Should you buy an annuity now?

These investments are selling faster than chocolates on Valentine's Day. But some can have unsavory effects on your savings.

To hear insurance companies, banks, and brokers tell it, annuities are about the best investment to come down the pike since Microsoft went public. Like an Individual Retirement Account (IRA), an annuity, which is an insurance contract, allows you to put money aside and pay no taxes on earnings until you withdraw funds, usually starting at age 59½.

You can opt for a fixed return or invest in a number of stock and bond mutual-fund-like portfolios. Unlike IRAs or 401(k)s, annuities set no top limit to what you can invest. And, you can pull out the money as a lump sum or "annuitize," transforming your savings into a guaranteed payment for life.

Aware that their depositors will be hard put to replace the 6 percent rate long-term CDs previously paid, banks, with a quick phone call or letter, are pushing annuities, particularly to retired people and customers with maturing CDs.

Even with tax advantages, annuities are often poor investments. They come with lofty fees and stiff withdrawal penalties. Another looming problem: the shaky financial condition of some of the insurance firms that stand behind these products. If an insurer goes out of business, you could lose some of your investment.

WHO NEEDS AN ANNUITY?

Annuities make sense only if you have no access to other tax-deferred accounts, like an IRA or 401(k), or if you have already maxxed them out. Even then, we recommend only fixed-rate annuities that provide a predictable return.

In this report, we'll explain how fixed-rate annuities work and arm you with information on money-draining variables. Finally, we identify four fixed-rate annuities from top-rated insurers that should give you a decent return.

IMMEDIATE ANNUITIES

Like everything else, annuities sort into different types. The classic annuity— now called an immediate annuity — is the kind Jane Austen wrote about. A beneficent relative invests a sum that produces a lifetime income for a dependent. Today, you can buy one for yourself from an insurance company that will pay you a set amount periodically after taking a generous cut for managing your money. When you die, any funds left over go to the insurer. For people who are fearful of managing their own retirement funds and have no dependents, such vehicles are heaven-sent. But there are other no-risk ways to get a stream of income, like laddered CDs or U.S. Treasury bonds.

A variation, the charitable gift annuity, also pays an income for life, but upon your death, the unused funds go to the nonprofit organization you choose. These annuities were not designed primarily to be investments but as a way for people to give to charity and receive a tax deduction up front—one calculated by a complex IRS formula. Before you commit to one, you should make sure that you have provided for your beneficiaries; you should also check out the charity to ensure it is for real and not a scam, and that it has the staying power to be around for the years you'll be relying on the income. (Like many other nonprofits, Consumers Union, the publisher of CONSUMER REPORTS, offers charitable gift annuities.)

DEFERRED ANNUITIES

These allow you to make a single payment or several payments that, when invested, build a fund on which you can draw, usually at retirement. A deferred annuity is generally inferior to an IRA, a 401(k), a Keogh, or other tax-deferred retirement arrangement because you not only get a tax deduction up front but lower fees and fewer restrictions.

Deferred annuities are subject to withdrawal rules that are similar to those of retirement plans: You generally may not remove funds before age 59½. without paying a 10 percent tax penalty and income taxes on your annuity's earnings. A deferred annuity, however, is less

Four fixed deferred annuities from solid firms

We asked Danny Fisher, the publisher of the Fisher Annuity Index, a database of about 1,000 fixed annuities (*www.mrannuity.com*), to find the 5- and 10-year CD-type annuities that pay the highest interest rates and that have an A- or higher rating from A.M. Best. The results are listed below. The policies may not be sold in all 50 states; call the toll-free number for more information.

COMPANY	A.M. BEST RATING	POLICY NAME	MINIMUM INVESTMENT	RATE	SURRENDER CHARGE, YEAR-ONE	TOLL-FREE NUMBER
10-YEAR						
ING USG Annuity & Life	A+	Max Guarantee	$50,000	5.00%	9% [2]	877-810-9051
Met Life Investors	A+	Fax	25,000	5.25	7 [2]	800-848-3854
5-YEAR						
Americom Life & Annuity	A-	Pledge Plus	25,000	4.65	8	888-604-2419
Fidelity & Guarantee Life	A	Platinum Plus 5	5,000	5.25 [1]	9 [2]	888-604-2419

[1] Guaranteed rate for year one; thereafter, rate is 4.25 percent. [2] May also have a market-value adjustment.

flexible than a retirement plan. If you need cash for an emergency, you'll have to pay a surrender charge, which averages around 5 percent but can run as high as 12 percent of the amount withdrawn if you take the money out in the first year of the contract. The surrender fee amount diminishes each year you stay in the annuity. So, if you are under age 59½ and you withdraw $25,000 of your earnings in the fifth year of a 10-year annuity, and the surrender fee is 5 percent, you could wind up minus $13,400; that's after paying that 5 percent surrender fee, a 10 percent tax penalty, and income taxes as high as 38.6 percent.

Many deferred annuities also levy a market-value adjustment, or MVA, an additional early withdrawal fee that kicks in if interest rates have risen since you bought your annuity. If interest rates have dropped, the MVA would boost your account balance. The surrender charge would apply to the higher amount.

FIXED-RATE ANNUITIES

Deferred annuities themselves come in two different flavors: fixed and variable. A **fixed-rate annuity**, as the name implies, pays a guaranteed rate of interest, sometimes higher than that of a CD. In December 2002, for example, many five-year annuities yielded 4 percent or higher vs. 3.6 percent for five-year CDs.

Most fixed annuities have a similar structure: an attractive, come-on rate for the first year, but no guarantee the insurer will set a rate above the minimum—right now about 3 percent—in later years. You can lock in a fixed rate of return for a specific period, however, with a CD-type annuity. This version guarantees a rate for a specific term, usually from 1 to 10 years. After that, you can renew it, roll it tax-free into another annuity, or just cash out.

A CD annuity makes sense because it offers predictable, steady interest payments. However, you should invest funds you won't need for the length of the contract, just as if you were investing in a bank CD.

Another option: Consider a deferred fixed-rate annuity that levies no surrender charge, such as TIAA-CREF's Personal Annuity Select (800-223-1200; *www.tiaacref.org*).

VARIABLE ANNUITIES

With a variable annuity, the second kind of deferred annuity, investors are not stuck with the mingy 3 or 4 percent returns of fixed annuities; they could instead reap market gains by putting their money into a mutual fundlike sub-account. Depending on the company selling it, investors could allocate their money to dozens of sub-accounts including very aggressive stock portfolios.

Variables—also insurance contracts—are horrible deals, however. Any long-term capital gains you earn in a variable annuity are taxed at ordinary income rates when you withdraw them, at or after retirement, rather than at the lower capital-gains rate. In other words, you are effectively converting capital gains that would be taxed at a rate that would not exceed 20 percent into ordinary income that could be hit with a rate as high as 38.6 percent.

Worse, in addition to a surrender charge, variable annuities come with two extra layers of expenses—management and marketing fees for each sub-account, which average 0.9 percent a year to more than 3 percent of assets, and insurance charges, which average 1.3 percent but can run as high as 1.85 percent a year.

> If you need cash fast, you could give up half your withdrawal paying a surrender charge and taxes.

WITHDRAWING YOUR STASH

When the time comes for you to start taking money out of your deferred annuity, you have a choice. You can withdraw the funds in one lump sum or in chunks as you need them. Or you can “annuitize” your withdrawals, which means converting your balance to a guaranteed lifetime income. You must pay taxes on your withdrawals, of course, but a portion is considered a return of your original capital and goes untaxed.

Taking out a lump sum will give you an immediate large tax bill. Annuitizing will keep it lower because the dribbles of taxable income you receive are less likely to boost you into a higher bracket. But, annuitizing means giving up access to the money in your account. So you'll have to maintain a cash stockpile to take care of emergencies. And, generally, when you die, the insurer—not a beneficiary—gets any remaining funds.

There are two ways to go: The insurance firm can provide you with a **fixed payout**, usually monthly, for the rest of your life. (You could also choose to get payments as long as you or your spouse is alive or for a specific number of years.) The size of your payment depends on several factors, including your life expectancy and the current level of interest rates—which may not keep up with inflation.

A **variable-payout** annuity, another option, guarantees payments for life but those payments fluctuate from month to month. It works like this: You or your insurer select an assumed interest rate or AIR—usually 3 percent or 6 percent. As in the accumulation stage, you divide your account balance among various stock and bond sub-accounts. If those earn a higher rate of return than your AIR, your monthly payments increase. If they earn less than the AIR, your payments decline. Once again, you'll pay management fees for all those sub-accounts.

QUALITY CHECK

If you do invest in an annuity, remember that although you may sign the contract at a bank or brokerage house, you are counting on the financial strength of the insurer that issues the annuity. The sluggish economy has hurt many insurers, and if a carrier goes under, you could lose a portion of your money.

To make sure the insurance company you choose has the financial strength to survive, use only products from companies that receive the highest or second highest ratings from insurance rating firms like A.M. Best (A++ to A-; *www.ambest.com*), or Moody's Investors Service (Aaa to Aa; *www.moodys.com*). If you own an annuity and the company is downgraded, Conrad Ciccotello, associate professor of risk management and insurance at the Robinson College of Business at Georgia State University, advises: “Like a relationship, you have to decide if it's worth breaking up. You'll have to weight the costs of leaving your old annuity against the benefits of the new one.”